



DEFENSE CONTRACT AUDIT AGENCY
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IN REPLY REFER TO

PSP 730.4.A.2/2006-001

September 29, 2011
11-PSP-017(R)

MEMORANDUM FOR REGIONAL DIRECTORS, DCAA
DIRECTOR, FIELD DETACHMENT, DCAA
HEADS OF PRINCIPAL STAFF ELEMENTS, HQ, DCAA

SUBJECT: Audit Guidance on Procedures for Reviewing Subcontract Commercial Items in
Forward Pricing Proposals

SUMMARY

During a proposal audit, auditors should perform procedures to evaluate the contractor's proposed costs for any significant subcontract costs for commercial items to ascertain if the proposed subcontract costs are fair and reasonable. When a prime/higher-tier contractor includes proposed subcontract costs for commercial items in its proposal, the prime/higher-tier contractor is required to make a commercial item determination (CID) and perform the appropriate cost or price analysis to establish a fair and reasonable price, in accordance with Department of Defense FAR Supplement (DFARS) 244.402 and Federal Acquisition Regulation (FAR) 15.404-3, respectively. The prime/higher-tier contract auditor is responsible for reviewing the adequacy of the prime/higher-tier contractor's CID and associated cost/price analysis as a basis for opining on the adequacy of the CID and the reasonableness of the proposed subcontract costs included in the prime/higher-tier contractor's proposal. Specific questions raised by auditors in relation to reviewing proposed commercial item subcontract costs are addressed in the Enclosure, Frequently Asked Questions.

Relevant FAR/DFARS Regulations

Prime contractors and all of their subcontractors are required to purchase supplies and services from responsible sources at fair and reasonable prices, including those determined to be commercial items. DFARS 244.402(a) states "Contractors shall determine whether a particular subcontract item meets the definition of a commercial item." Prime/higher-tier contractors are expected to exercise reasonable business judgment in making the CID and documenting its determination. In addition, FAR 15.404-3(b) states that the prime contractor shall conduct appropriate cost/price analyses to establish the reasonableness of proposed subcontract prices and include these analyses in its proposal.

Generally, there is no FAR requirement for the contracting officer to approve each subcontract CID (see DFARS Change Regarding Acquisition of a Major Weapon System for an exception on page 4). However, the contracting officer may disagree with a prime/higher-tier contractor's CID. FAR 15.403-1(c)(3) states in part, "If the contracting officer determines that an

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item claimed to be commercial is, in fact, not commercial and that no other exception or waiver applies, ... the contracting officer shall require submission of certified cost or pricing data.”

AUDIT GUIDANCE

When performing an examination of a proposal that contains subcontract costs for commercial items, the prime contract auditor should review and opine on the adequacy of (1) the actions taken by the prime contractor in making the CID and (2) the associated cost/price analysis in determining that the price is fair and reasonable. Failure to follow policies and procedures or the FAR/DFARS and complete required CIDs and cost/price analyses on commercial items is considered a significant estimating deficiency and a flash report should be issued.

Analyzing the Prime/Higher-Tier Contractor's CID

An adequate CID clearly identifies and supports how the item meets the commercial item definition in FAR 2.101. Generally, support for a CID would include market analysis and sales history. Audit teams should consider coordinating with the Contracting Officer to ascertain whether, in the past, the Contracting Officer has either deemed a subcontractor CID as adequate or inadequate to assist in planning appropriate procedures. However, audit teams should avoid excessive reliance on past conclusions as conditions may have changed (e.g., the item may have been substantially modified). Technical assistance should also be requested, if necessary, to support the review of the prime contractor's analysis for aspects such as items that are “of a type,” “evolved,” or “modifications.”

Opining on the Prime/Higher-Tier Contractor's Cost/Price Analysis

Auditors should opine on the adequacy of the contractor's cost/price analysis for determining a fair and reasonable price. The cost/price analysis performed by the prime/higher-tier contractor may include pricing and sales data and/or data other than certified cost or pricing data. The prime/higher-tier contractor will conduct a price analysis to examine and evaluate the proposed price without evaluating its separate cost elements and proposed profit (typically using one or more of the techniques specified in FAR 15.404-1(b)(2)). If the prime/higher-tier contractor cannot determine reasonableness through price analysis, cost analysis may also be used to evaluate data other than certified cost or pricing data. Based on materiality and risk, the prime contractor should verify subcontractor supporting data (sales and/or cost based) to the subcontractor's books and records. (See below for assessing the need for an assist audit.) If the prime contractor is denied access, it should perform procedures to the extent possible, and notify the contracting officer of limitations imposed by the subcontractor and the effect on the cost/price analysis.

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Audit Team Actions When the CID Is Incomplete or Not Adequate

If the auditor determines that the prime/higher-tier contractor has not completed the required CID or it is inadequate, the auditor should immediately discuss the issues with the Contracting Officer verbally and recommend that the Contracting Officer require the prime contractor to perform an adequate CID. This communication should be confirmed in writing. The audit team should proceed with the review of the prime/higher-tier contractor's cost/price analysis and assess whether the subcontract amount represents fair and reasonable pricing.

When the CID is still not completed or remains inadequate after the first notification, inform the Contracting Officer of the prime/higher-tier contractor's lack of action or inadequate support. In addition, coordinate with the Contracting Officer that he/she may need to request certified cost or pricing data if there is not an adequate CID. If either the CID or cost/price analysis is not complete or is inadequate, the proposed amount, less any questioned costs, should be classified as unsupported. Include in the price proposal audit report a finding regarding the lack of support for the CID, the results of your audit of the cost/price analysis, and a recommendation that certified cost or pricing data will need to be requested. In these circumstances, depending on the dollar value of the subcontract versus the overall proposal, the audit team may need to qualify the report as additional questioned cost could be identified should the Contracting Officer require the submission of certified cost or pricing data.

Assist Agreed-Upon Procedure Engagements/Audits

Under certain circumstances, the auditor may determine the need for an assist audit (e.g., prime's analysis is inadequate, prime is denied access to subcontractor's data, close business relationship between prime and subcontractor, size of the proposed subcontract in relation to the prime proposal, etc.). Audit teams at the prime/higher-tier contract level should coordinate with the audit team cognizant of the subcontract level to ensure understanding of the assistance required and data available. Depending on the type of information or data supporting the prime contractor's CID and price reasonableness analysis, different procedures should be applied, as follows.

Commercial Subcontract Costs Based on Sales or Pricing Data

If the analysis is supported by sales or pricing data, the prime contract auditor should request the subcontract auditor, using an agreed upon procedures (AUP) engagement, to compare the sales/price data asserted to the prime contractor to the subcontractor's accounting records and report any differences. This information will assist the prime contract auditor in reaching an opinion as to whether (1) the proposed item meets the definition of a commercial item and (2) the proposed price is fair and reasonable.

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If the sales/prices provided to the prime contractor are incomplete, request the prime contractor to obtain additional data from the subcontractor regarding sales/price information including part number, invoice data, unit price, ancillary costs (shipping, warranty, etc.), quantity, customer, etc., prior to requesting an AUP. If the subcontractor has refused to provide to the prime/higher-tier contractor the sales/pricing data, then the prime/higher-tier contractor should notify the Contracting Officer. The Contracting Officer and/or audit team should request the sales information or other supporting data. The audit team cognizant of the prime/higher-tier contractor should evaluate the supporting data to determine whether an AUP engagement is needed on the subcontract. The subcontract audit team should appropriately restrict release of the AUP report to the prime/higher-tier contractor, as determined by the subcontractor, following CAM 10-212.3 and 10-307.2.

Sales data must be comparable to the quantities, capabilities and specifications of the product or service proposed. CAM 14-1000 contains guidance for performing AUP engagements. The procedures should be communicated between the prime and subcontract auditors and not require the subcontract auditor to form an opinion or make recommendations. When an AUP report is received, the prime contract auditor will draw a conclusion based on the results of the AUP, incorporate any findings into the prime contract audit report, and if performing an examination, render an opinion considering the totality of evidence reviewed, which includes the AUP.

Commercial Subcontract Costs based on Cost Data

When the commercial item subcontract price is supported by cost-based data (i.e., “data other than certified cost or pricing data”), auditors should follow the general guidance in CAM 9-104.2 in determining the need for an assist audit. When an audit is requested, the subcontract auditor should opine on whether the data other than certified cost or pricing data is acceptable for use in determining a fair and reasonable subcontract price.

DFARS Change Regarding Acquisition of a Major Weapon System

Auditors should also be aware that DFARS 234.70 – *Acquisition of Major Weapon Systems as Commercial Items*, paragraph 7002, *Policy*, has special requirements. If the item being acquired by the prime or higher-tier contractor is a subsystem for a major weapon system, DFARS 234.7002 requires the contracting officer to make an independent written CID in addition to the prime/higher-tier contractor’s CID and to be able to determine the reasonableness of the price through price analysis. Similar requirements apply to major weapon system components or spare parts. In either case, the contracting officer’s CID is not required for the auditor at the prime contractor/higher-tier contractor level to review and opine on the prime/higher-tier contractor’s CID and associated cost/price analysis. In most cases, the Contracting Officer will be using the prime/higher-tier contractor’s CID and associated

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cost/price analysis and our audit opinion to assist in supporting his/her independent determination. When a request to audit a major weapon system and its proposed subcontracts is received, the audit team should coordinate with the Contracting Officer as to whether the weapon system is being procured as a commercial item and, if so, whether the Government CID has been completed. Close coordination will be required with the Contracting Officer as the major weapon system cannot be procured as a commercial item without a Secretary of Defense determination or a Contracting Officer determination on the subsystem, component, or spare part. Audit teams should elevate issues to the Region when Secretary of Defense/Contracting Officer commercial item decisions on major weapon systems or the subsystems, components and spare parts affect audit accomplishment.

CONCLUDING REMARKS

If FAO personnel have any questions, they should contact regional personnel. Regional personnel with any questions should contact Pricing and Special Projects Division at (703) 767-3290 or email at DCAA-PSP@dcaa.mil.

/Signed/
Kenneth J. Saccoccia
Assistant Director
Policy and Plans

Enclosure:
Frequently Asked Questions

DISTRIBUTION: C

FREQUENTLY ASKED QUESTIONS

Question 1: If the prime/higher-tier contractor did not document a commercial item determination (CID) or perform a price analysis on a proposed commercial subcontract should the amount be unsupported?

Answer: Yes. The prime/higher-tier contractor is responsible for making a CID (DFARS 244.402(a)) and performing a price analysis on a commercial item subcontract (FAR 15.404-3(b)). The auditor should notify the requester, Contracting Officer, and FLA, if applicable, and issue an estimating flash report (CAM 9-104.2b).

Question 2: If the prime contractor/higher-tier contractor bases its price analysis on historical sales to itself should the price analysis be considered adequate?

Answer: No. The prime contractor/higher-tier subcontract auditor should determine if there were sales to other commercial customers as part of the review of the price analysis and request the prime contractor to obtain additional data regarding sales/price information from the subcontractor including part number, invoice data, unit price, ancillary costs (e.g. shipping, warranty, etc.), quantity, customer, etc. FAR 15.403-3(a)(1) states if there is not adequate information from sources other than the offeror, at a minimum, there should be appropriate information on the prices at which the same item or similar items have previously been sold. FAR 15.403-1(c)(3) states that the prices should be under comparable terms and conditions by both Government and commercial customers. If the prime/higher-tier contractor is unable to determine if the price is reasonable based on sales data and no other market-based data is available, they must obtain and evaluate data other than certified cost or pricing data, which can include cost information in order to establish that the subcontract price is reasonable (FAR 15.403-3(c) and DFARS PGI 215.404-1(b)(ii)).

Question 3: Is a prime contractor's determination of a fair and reasonable price based solely on a catalog price acceptable?

Answer: No. FAR 15.403-3(c)(1) states that the fact that a price is included in a catalog does not, in and of itself, make it fair and reasonable. Auditors should also be alert to catalog pricing that does not take into account quantity discounts. Auditors may find it necessary to either evaluate prior historical sales of the item to the prime/higher-tier contractor to determine the existence of discounts and request agreed-upon procedures (AUPs) be performed at the subcontractor, if needed.

Question 4: Does the Contracting Officer need to approve a prime/higher-tier contractor-level CID for the subcontract?

Answer: Generally, no. DFARS 244.402(a) states that "Contractors shall determine whether a particular subcontract item meets the definition of a commercial item." However, FAR 15.403-1(c)(3) provides that "If the contracting officer determines that an item claimed to be commercial is, in fact, not commercial and that no other exception or waiver applies, ... the

contracting officer shall require submission of certified cost or pricing data.” This means the contracting officer can choose to step in if he/she believes there are issues with the CID as accomplished by the prime contractor. DFARS 234.7002 provides special rules for acquiring a major weapon system or its subsystems, components or spare parts as commercial items requiring either the Secretary of Defense for the entire major weapon system or the Contracting Officer for subsystems, components and spare parts to make a Government determination on commerciality.

Question 5: The prime/higher-tier contractor develops a CID but is unable to perform a complete price analysis (i.e., verification of subcontract sales data) because the subcontractor will not release the information to the prime contractor. Should the auditor classify the subcontract costs as unsupported?

Answer: No, provided the prime/higher-tier contractor has attempted to accomplish a complete price analysis and documented the unsuccessful efforts in its proposal and elevated it to the Administrative Contracting Officer (ACO)/Contracting Officer to request assistance so that a price analysis can be performed. DFARS PGI 215.404-3(a) discusses situations where the ACO or Contracting Officer will provide assistance to the contractor at any tier when they are denied access to a subcontractor’s records in carrying out the responsibilities at FAR 15.404-3 (conduct price or cost analysis). Note that the prime contractor should not be relieved from performing a portion of the required price analysis techniques such as, market analysis. A government representative (Contracting Officer, ACO, or auditor) should request the subcontractor to provide the needed supporting data such as, relevant sales. The audit team cognizant of the prime/higher-tier contractor should determine if they can evaluate the provided data or will need to request assistance.

Question 6: The prime/higher-tier contractor has not submitted adequate support of its CID, but has performed a cost/price analysis. Should the auditor evaluate the cost/price analysis?

Answer: Yes. The auditor’s evaluation of the cost/price analysis review will provide the contracting officer with input to assist him/her in fulfilling the FAR 15.404-3(a) requirement that the contracting officer is responsible for the determination of price reasonableness for the prime contract, including subcontract costs. The proposed amount, less any questioned cost, should still be shown as unsupported as the prime contractor has failed to fulfill its obligation under DFARS 244.402(a) in supporting a commercial item determination. In addition to reporting the results of the evaluation of the cost/price analysis, the auditor should report to the contracting officer any CID inadequacies and recommend that the contracting officer require the prime/higher tier contractor provide certified cost or pricing data in support of the proposed subcontractor costs in the absence of other exceptions.

Question 7: Commercial items are defined by FAR 2.101, *Definitions*, as “any item, other than real property, that is of a type customarily used by the general public or by non-governmental entities for purposes other than governmental purposes, and – (i) has been sold, leased, or licensed to the general public; or, (ii) has been offered for sale, lease, or license to the general public What does the term “general public” in the commercial item definition mean?

Answer: The term “general public” is intended to not only include private consumers, but may also include commercial companies. If the item being sold is customarily of a type that is used by organizations for other than governmental purposes, and it has been sold, leased or licensed to commercial companies, or offered as such, it may qualify as a commercial item under the FAR 2.101 definition. Therefore, sales to commercial companies may qualify but only if the end user is an organization other than governmental. DFARS 202.101 defines that “general public” does not include the Federal Government, or State, local, or foreign government.

Question 8: A contractor routinely uses the same supporting data for its CID when proposing effort from a particular commercial subcontractor. The FAO has not taken exception to the CID in the past. In evaluating the CID and the reasonableness of the proposed subcontract costs in subsequent price proposals, should the audit team simply document that we have taken no exception to the contractor’s CID in the past and rely on past price reasonableness evaluations?

Answer: No. The audit team should evaluate the contractor’s CID and price analysis prepared for the instant proposal and the supporting data/rationale. Auditors may use past audit work to assist in the current audit; however, the auditor must verify that the evidence continues to apply to the unique set of circumstances in the instant audit. For example, the item in question may have been substantially modified subsequent to the contractor’s initial CID and the sales used to support the contractor’s conclusions are no longer valid. While evidence prepared by the contractor in support of past procurements may be helpful, auditors should avoid placing sole reliance in that evidence without considering its continued validity based on changed conditions.